

Perpetual knowledge bank series: Asset Securitisation

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Securitisation is the process of pooling financial assets (typically illiquid assets) and converting them into one financial instrument. Securitised assets are generally issued by special purpose vehicles, such as trusts or companies, that hold the assets.

A security is any tradable financial asset that holds some type of monetary value. Securitisation therefore describes the process of pooling usually illiquid financial assets and turning them into tradable securities. The most obvious example is home mortgages, which would be the underlying financial assets in a residential mortgage-backed security (RMBS) that can then be divided up and sold to investors in separate tranches. The interest and principal on the mortgages are used to pay interest and repay principal on the RMBS that are issued. Other asset-backed securities may include commercial mortgage backed securities (CMBS), auto loans, credit card debt, bank loans to businesses and other types of leases. This trend has evolved rapidly in Australia over the past 20 years with the securitisation of residential mortgages leading the growth in this market.

While securitised products are valued based on the cash flows of the underlying assets, these products can be hard to analyse. For example, mortgage-backed securities played a central role in the Global Financial Crisis (GFC) of 2008. US subprime loans such as mortgages were packaged together into large pools of loans and sold to investors with the assumption that even if some defaulted, the mortgage pools would remain sound investments. However, falling house prices and borrowers unable to pay their loans saw the value of these investments plummet, helping to fuel the GFC.

Since the GFC, regulators globally have cracked down on securitisation transactions based on the 'originate to distribute' model, where lenders originate new loans (such as residential or commercial mortgages) for the sole purpose of selling them into special purpose vehicles (SPV). This has put a far greater emphasis on originators to consider the quality of the loans being packaged up and not just the volume to protect securitisation investors.

The Perpetual Credit Income Trust (ASX: PCI) aims to provide investors with monthly income by investing in a diversified pool of credit and fixed income assets. This includes investing in RMBS and CMBS alongside other types of securities such as fixed bonds, floating rate notes and loans. RMBS and CMBS can provide attractive sources of income for the portfolio via their coupon payments. The predictability of these coupon payments is typically high as they are an obligation from the borrower to PCI, as opposed to dividend payments from listed companies which are at the discretion of the respective Board.

Importantly, Perpetual employs a robust, active and risk aware investment process to determine the most attractive credit investment opportunities on a risk-adjusted basis at any point in time. This includes how RMBS and CMBS can complement other securities in the PCI portfolio to ensure it is well diversified across issuers, sectors, asset types, maturities and countries.

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